Is Another Oil Price Collapse Imminent?

Description

Crude's latest rally, which saw the international benchmark Brent reach a multiyear high and West Texas Intermediate (WTI) climb to trade at over US$70 a barrel, has fueled further bullishness over the outlook for petroleum. Some analysts have claimed that oil will reach US$100 per barrel before the year's end. Much of this optimism is focused on a range of emerging supply constraints, which have buoyed expectations of higher oil prices. This has been a boon for Canada's oil patch with some companies, such as **MEG Energy** (TSX:MEG), outstripping oil and surging by over 45%.

Nonetheless, many others, such as **Crescent Point** and **Whitecap Resources** have failed to keep pace. This is because there are still considerable concerns over the outlook for crude and that it could once again pullback sharply to as low as US$60 per barrel or less over coming months.

Now what?

A notable proponent of weaker oil is Russia's Finance Ministry, which warned in July 2018 that oil was trading well above its equilibrium price and would fall between US$50 and US$60 a barrel. Global head of commodities at **Citigroup** Ed Morse stated around the same time that crude, in approximately a year, was headed to somewhere between US$45 and US$65 a barrel.

He based his hypothesis on the view that the constraints, which many analysts believe will cause global supply to diminish in an environment where demand remains strong, are overstated and not as severe as believed. Morse also believes that supply can keep pace with demand. There are indications that this could very well be the case with many of the factors hindering production being artificially induced.

You see, Saudi Arabia and Russia have resisted calls from Trump to open the spigots and bolster production to lower prices. There is considerable evidence that they are comfortable with Brent trading at around US$80 a barrel. This is because, according to the International Monetary Fund, Riyadh needs Brent to average around US$85 a barrel to balance its budget, while, for Russia, analysts believe it to be US$80 per barrel.

For this reason, it is unlikely that either nation will consider boosting output beyond what is required to keep prices around their required breakeven price. Even with the reinstatement of sanctions on Iran looming, neither have made any move to bolster their oil output.

Among the greatest threats to higher oil is Trump's protectionist approach to trade. He has effectively threatened to place tariffs on all U.S. imports from China. Beijing has stated that it will retaliate if this occurs. A full-blown global trade war would crimp economic growth and, according to some economists, shave up to 1.4% off global GDP over a two-year period.

The fallout from such a conflict would be widespread, impacting a range of national economies, particularly those emerging markets that are highly dependent on producing the commodities, such as base metals and coal, which are primarily consumed by China. That would cause demand for petroleum to fall sharply as the economies of those nations deteriorate. This — along with growing U.S. shale production and considerable global oil inventories, notably in Saudi Arabia — could cause crude to crash.

So what?

Even if oil plunged once again, it is difficult to see it plumbing the lows witnessed at the height of the oil slump, where crude tumbled to under US$30 a barrel in early 2016. The combination of stronger demand growth and existing supply constrictions should work together to keep WTI range bound between US$60 and US$70 a barrel. While that would be disappointing for Canadian energy investors, it doesn't spell the end of the rally in energy stocks.

There are even indications that MEG, which has significantly outstripped oil since the start of the year, could rally further if oil dropped to US$60 per barrel. This is because it reported some remarkable results, indicating including record July 2018 production of 98,000 barrels daily and a new low for operating costs during the second quarter 2018 of $5.64 per barrel produced. MEG also revised its 2018 guidance higher, increasing forecast oil output by 2% to somewhere between 87,000 and 90,000 barrels daily. Each of these factors — along with a stronger balance sheet — indicate that MEG's earnings will continue to grow even if crude weakens, positioning its stock for further gains.

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